Product Gross Margin

Product gross margin percentage decreased by 1.3% compared to fiscal 2004. Changes in the mix of products sold decreased product gross margin percentage by approximately 2.5% due to higher sales of certain lower-margin switching products and increased sales of home networking products. Product pricing reductions and sales discounts decreased product gross margin percentage by approximately 2%. In addition, a higher provision for warranty and a higher provision for inventory decreased product gross margin percentage by approximately 0.5%. However, lower overall manufacturing costs related to lower component costs and value engineering and other manufacturing-related costs increased product gross margin percentage by approximately 2%. Higher shipment volumes also increased product gross margin percentage by approximately 1.5%.

Service Gross Margin

Service gross margin percentage decreased by 1.8% compared to fiscal 2004. The decrease in service gross margin percentage was primarily due to increased investments in the service portion of our business during fiscal 2005. One specific area of investment is advanced services, comprising highly specialized employees. As we add personnel and resources to support growth in this business, our service margins will typically be adversely affected in the near term. We also added investments in our technical support business during fiscal 2005.

Research and Development, Sales and Marketing, and General and Administrative Expenses

R&D expenses in fiscal 2005 were higher primarily due to higher headcount-related expenses of approximately $75 million and higher discretionary spending of approximately $35 million. We have continued to invest in R&D activities and to purchase or license technology in order to bring a broad range of products to market in a timely fashion. If we believe that we are unable to enter a particular market in a timely manner with internally developed products, we may license technology from other businesses or acquire businesses as an alternative to internal R&D. All of our R&D costs have been expensed as incurred.

Sales and marketing expenses in fiscal 2005 increased due to higher sales expenses of $151 million and higher marketing expenses of $40 million. Sales expenses increased primarily due to the effect of foreign currency fluctuations of approximately $100 million, net of hedging; and an increase in headcount-related expenses of approximately $60 million (including an adjustment of approximately $40 million relating to fiscal 2004 which reduced sales commissions). Marketing expenses increased in fiscal 2005 primarily due to various marketing programs globally and other marketing investments.

The increase in our G&A expenses in fiscal 2005 was primarily attributable to costs incurred associated with various compliance programs and expenses related to investments in internal information technology systems and related program spending.

Our headcount increased by 4,042 employees in fiscal 2005, of which approximately 1,200 new employees were attributable to acquisitions we completed in fiscal 2005.

Amortization of Purchased Intangible Assets

Amortization of purchased intangible assets included in operating expenses was $227 million in fiscal 2005, compared with $242 million in fiscal 2004. For additional information regarding purchased intangibles, see Note 3 to the Consolidated Financial Statements.

In-Process Research and Development

The following table summarizes the key assumptions underlying the valuation for our purchase acquisitions completed in fiscal 2005 and fiscal 2004, for which in-process R&D was recorded (in millions, except percentages):

	In-Process R&D Expense	Estimated Cost to Complete Technology at Time of Acquisition	Risk-Adjusted Discount Rate for In-Process R&D
FISCAL 2005			
Actona Technologies, Inc.	$ 4	$ 1	24.0%
Airespace, Inc.	3	1	22.0%
P-Cube Inc.	6	2	24.0%
Topspin Communications, Inc.	4	2	21.0%
Other	9	5	20.0%–23.0%
Total	$26	$11	
FISCAL 2004			
Latitude Communications, Inc.	$ 1	$ 1	16.5%
Other	2	1	23.0%
Total	$ 3	$ 2	

Interest Income, Net

The increase in interest income was primarily due to higher average interest rates on our portfolio of cash and cash equivalents and fixed-income securities, partially offset by a decrease in the average portfolio balance.

Other Income, Net

The components of other income, net, are as follows (in millions):

Years Ended	July 30, 2005	July 31, 2004
Net gains on investments in fixed income and publicly traded equity securities	$ 88	$ 206
Impairment charges on publicly traded equity securities	(5)	—
Net gains on investments in privately held companies	51	61
Impairment charges on investments in privately held companies	(39)	(112)
Net gains and impairment charges on investments	95	155
Other	(27)	33
Total	$ 68	$ 188

Provision for Income Taxes

The effective tax rate was 28.6% for fiscal 2005 and 28.9% for fiscal 2004. The effective tax rate differs from the statutory rate primarily due to acquisition-related costs, research and experimentation tax credits, state taxes, and the tax impact of foreign operations.

In fiscal 2005, the Internal Revenue Service completed its examination of our federal income tax returns for the fiscal years ended July 25, 1998 through July 28, 2001. Based on the results of the examination, we decreased previously recorded tax reserves by approximately $110 million and decreased income tax expense by a corresponding amount. This decrease to the provision for income taxes was offset by increases to the provision for income taxes of $57 million related to a fourth quarter fiscal 2005 intercompany restructuring of certain of our foreign operations and $70 million related to the effect of U.S. tax regulations effective in fiscal 2005 that require intercompany reimbursement of certain stock-based compensation expenses.

Cumulative Effect of Accounting Change, Net of Tax

In April 2001, we entered into a commitment to provide convertible debt funding of approximately $84 million to Andiamo Systems, Inc. ("Andiamo"), a privately held storage switch developer. This debt was convertible into approximately 44% of the equity of Andiamo. In connection with this investment, we obtained a call option that provided us the right to purchase Andiamo. The purchase price under the call option was based on a valuation of Andiamo using a negotiated formula. On August 19, 2002, we entered into a definitive agreement to acquire Andiamo, which represented the exercise of our rights under the call option. We also entered into a commitment to provide nonconvertible debt funding to Andiamo of approximately $100 million through the close of the acquisition. Substantially all of the convertible debt funding of $84 million and nonconvertible debt funding of $100 million was expensed as R&D costs.

We adopted FASB Interpretation No. 46(R), "Consolidation of Variable Interest Entities" ("FIN 46(R)"), effective January 24, 2004. We evaluated our debt investment in Andiamo and determined that Andiamo was a variable interest entity under FIN 46(R). We concluded that we were the primary beneficiary as defined by FIN 46(R) and, therefore, accounted for Andiamo as if we had consolidated Andiamo since our initial investment in April 2001. The consolidation of Andiamo from the date of our initial investment required accounting for the call option as a repurchase right. Under FASB Interpretation No. 44, "Accounting for Certain Transactions Involving Stock Compensation," and related interpretations, variable accounting was required for substantially all Andiamo employee stock and options because the ending purchase price was primarily derived from a revenue-based formula.

Effective January 24, 2004, the last day of the second quarter of fiscal 2004, we recorded a noncash cumulative stock compensation charge of $567 million, net of tax (representing the amount of variable compensation from April 2001 through January 2004). This charge was reported as a separate line item in the Consolidated Statements of Operations as a cumulative effect of accounting change, net of tax. The charge was based on the value of the Andiamo employee stock and options and their vesting from the adoption of FIN 46(R) pursuant to the formula-based valuation.

On February 19, 2004, we completed the acquisition of Andiamo, exchanging approximately 23 million shares of our common stock for Andiamo shares not owned by us and assuming approximately 6 million stock options, for a total estimated value of $750 million, primarily derived from the revenue-based formula, which after stock price-related adjustments resulted in a total amount recorded of $722 million as summarized in the table below.

Subsequent to the adoption of FIN 46(R), changes to the value of Andiamo and the continued vesting of the employee stock and options resulted in an adjustment to the noncash stock compensation charge. We recorded a noncash variable stock compensation adjustment of $58 million in the third quarter of fiscal 2004 to the cumulative stock compensation charge recorded in the second quarter of fiscal 2004 to account for the additional vesting of the Andiamo employee stock and options and changes in the formula-based valuation from January 24, 2004 until February 19, 2004. This noncash adjustment was reported as R&D expense of $52 million and sales and marketing expense of $6 million in the Consolidated Statements of Operations, as stock-based compensation related to acquisitions and investments in the Consolidated Statements of Cash Flows, and as an increase to additional paid-in capital in the Consolidated Statements of Shareholders' Equity. In addition, upon completion of the acquisition, deferred stock-based compensation of $90 million was recorded to reflect the unvested portion of the formula-based valuation of the Andiamo employee stock and options. See Note 3 to the Consolidated Financial Statements. The amount of deferred stock-based compensation was fixed at the date of acquisition and was being amortized over the vesting period of the Andiamo employee stock and options of approximately two years.

A summary of the accounting of the initial consolidation under FIN 46(R) and the subsequent purchase of Andiamo, after stock price-related adjustments, is as follows (in millions):

	Amount
Cumulative effect of accounting change, net of tax benefit of $5	$ 567
Variable stock-based compensation	58
Deferred stock-based compensation	90
Net assets	7
Total	$ 722

Recent Accounting Pronouncement

In July 2006, the FASB issued Financial Interpretation No. 48, "Accounting for Uncertainty in Income Taxes-an interpretation of FASB Statement No. 109" ("FIN 48"), which is a change in accounting for income taxes. FIN 48 specifies how tax benefits for uncertain tax positions are to be recognized, measured, and derecognized in financial statements; requires certain disclosures of uncertain tax matters; specifies how reserves for uncertain tax positions should be classified on the balance sheet; and provides transition and interim-period guidance, among other provisions. FIN 48 is effective for fiscal years beginning after December 15, 2006 and as a result, is effective for us in the first quarter of fiscal 2008. We are currently evaluating the impact of FIN 48 on our Consolidated Financial Statements.

Liquidity and Capital Resources

The following sections discuss the effects of changes in our balance sheet and cash flows, contractual obligations, other commitments, and the stock repurchase program on our liquidity and capital resources.

Balance Sheet and Cash Flows

Cash and Cash Equivalents and Investments The following table summarizes our cash and cash equivalents and investments (in millions):

	July 29, 2006	July 30, 2005	Increase (Decrease)
Cash and cash equivalents	**$ 3,297**	$ 4,742	$ (1,445)
Fixed income securities	**13,805**	10,372	3,433
Publicly traded equity securities	**712**	941	(229)
Total	**$17,814**	$16,055	$ 1,759

The increase in cash and cash equivalents and investments was primarily a result of cash provided by operating activities of $7.9 billion, the issuance of debt of $6.5 billion, and cash provided by the issuance of common stock of $1.7 billion related to employee stock option exercises and employee stock purchases, partially offset by cash used for the repurchase of common stock of $8.3 billion, acquisitions of businesses of $5.3 billion net of cash, cash equivalents, and investments acquired, and capital expenditures of $772 million.

Effective October 29, 2005, we changed the method of classification of our investments previously classified as long-term investments to current assets, and the balances for the prior years have been reclassified to conform to the current year's presentation. This new method classifies these securities as current or long-term based on the nature of the securities and the availability for use in current operations while the prior classification was based on the maturities of the investments. We believe this method is preferable because it is more reflective of our assessment of the overall liquidity position.

As of July 29, 2006, approximately $6 billion of our cash and cash equivalents and investments was held in the United States. The remainder of our cash and cash equivalents and investments was held outside of the United States in various foreign subsidiaries. If these cash and cash equivalents and investments were distributed to the United States in the form of dividends or otherwise, we would be subject to additional U.S. income taxes (subject to an adjustment for foreign tax credits) and foreign withholding taxes.

We expect that cash provided by operating activities may fluctuate in future periods as a result of a number of factors, including fluctuations in our operating results, shipment linearity, accounts receivable collections, inventory management, excess tax benefits from stock-based compensation, and the timing and amount of tax and other payments. Shipment linearity is a measure of the level of shipments throughout a particular quarter. For additional discussion, see Part I, Item 1A. Risk Factors in our Annual Report on Form 10-K.

Accounts Receivable, Net The following table summarizes our accounts receivable, net (in millions):

	July 29, 2006	July 30, 2005	Increase (Decrease)
Accounts receivable, net	$3,303	$2,216	$1,087

The increase in accounts receivable was due to increased sales and the addition of approximately $240 million of accounts receivable related to Scientific-Atlanta. Days sales outstanding in accounts receivable (DSO) as of July 29, 2006 and July 30, 2005 was 38 days and 31 days, respectively. Our DSO is primarily impacted by shipment linearity and collections performance. A steady level of shipments and good collections performance will result in reduced DSO compared with a higher level of shipments toward the end of a quarter, which will result in a shorter amount of time to collect the related accounts receivable and increased DSO.

Inventories The following table summarizes our inventories (in millions):

	July 29, 2006	July 30, 2005	Increase (Decrease)
Raw materials	$ 131	$ 82	$ 49
Work in process	377	431	(54)
Finished goods:			
Distributor inventory and deferred cost of sales	423	385	38
Manufacturing finished goods	236	184	52
Total finished goods	659	569	90
Service-related spares	170	180	(10)
Demonstration systems	34	35	(1)
Total	$1,371	$1,297	$ 74

Annualized inventory turns were 8.5 in the fourth quarter of fiscal 2006 compared to 6.6 in the fourth quarter of fiscal 2005. Scientific-Atlanta contributed approximately $150 million of inventory at July 29, 2006. Our finished goods consist of distributor inventory and deferred cost of sales and manufacturing finished goods. Distributor inventory and deferred cost of sales are related to unrecognized revenue on shipments to distributors and retail partners and shipments to enterprise and service provider customers. Manufacturing finished goods consist primarily of build-to-order and build-to-stock products. Service-related spares consist of reusable equipment related to our technical support and warranty activities. All inventories are accounted for at the lower of cost or market.

In the third quarter of fiscal 2006, we began the initial implementation of the lean manufacturing model. Lean manufacturing is an industry-standard model that seeks to drive efficiency and flexibility in manufacturing processes and in the broader supply chain. Over time, consistent with what we have experienced thus far, we expect this process will result in incremental increases in purchase commitments with contract manufacturers and suppliers and corresponding decreases in manufacturing inventory. Inventory management remains an area of focus as we balance the need to maintain strategic inventory levels to ensure competitive lead times with the risk of inventory obsolescence because of rapidly changing technology and customer requirements. We believe the amount of our inventory is appropriate for our revenue levels.

Deferred Revenue The following table presents the breakdown of deferred revenue (in millions):

	July 29, 2006	July 30, 2005	Increase (Decrease)
Service	$ 4,088	$ 3,618	$ 470
Product	1,561	1,424	137
Total	$ 5,649	$ 5,042	$ 607
Reported as:			
Current	$ 4,408	$ 3,854	$ 554
Noncurrent	1,241	1,188	53
Total	$ 5,649	$ 5,042	$ 607

The increase in deferred service revenue reflects the impact of the increase in the volume of technical support contract initiations and renewals, partially offset by the ongoing amortization of deferred service revenue. The increase in deferred product revenue was related primarily to the timing of cash receipts related to unrecognized revenue from two-tier distributors.

Long-Term Debt The following table summarizes our long-term debt as of July 29, 2006 (in millions, except percentages):

	Amount	Effective Rate[1]
Senior notes:		
2009 Notes	$ 500	5.27%
2011 Notes	3,000	5.39%
2016 Notes	3,000	5.62%
Total senior notes	6,500	
Other notes	5	
Unamortized discount	(18)	
Fair value adjustment	(155)	
Total	$ 6,332	

(1) The effective rates for the 2011 Notes and the 2016 Notes reflect the variable rate in effect as of July 29, 2006 on the interest rate swaps designated as fair value hedges of those notes, including the amortization of the discount.

In February 2006, we issued $500 million of senior floating interest rate notes due 2009 (the "2009 Notes"), $3.0 billion of 5.25% senior notes due 2011 (the "2011 Notes") and $3.0 billion of 5.50% senior notes due 2016 (the "2016 Notes"), for an aggregate principal amount of $6.5 billion. The debt issuance was used to fund the acquisition of Scientific-Atlanta and for general corporate purposes. The 2011 Notes and the 2016 Notes are redeemable by us at any time, subject to a make-whole premium. To achieve our interest rate objectives, we entered into $6.0 billion notional amount of interest rate swaps. In effect, these swaps convert the fixed interest rates of the 2011 Notes and the 2016 Notes to floating interest rates based on LIBOR. Gains and losses in the fair value of the interest rate swaps offset changes in the fair value of the underlying debt. See Note 8 to the Consolidated Financial Statements. We were in compliance with all debt covenants as of July 29, 2006.

Contractual Obligations

Our cash flows from operations are dependent on a number of factors, including fluctuations in our operating results, shipment linearity, accounts receivable collections, inventory management, excess tax benefits from stock-based compensation, and the timing and amount of tax and other payments. As a result, the impact of contractual obligations on our liquidity and capital resources in future periods should be analyzed in conjunction with such factors. In addition, we plan for and measure our liquidity and capital resources through an annual budgeting process.

Management's Discussion and Analysis of Financial Condition and Results of Operations

The following tables summarize our contractual obligations at July 29, 2006 and July 30, 2005 (in millions):

		PAYMENTS DUE BY PERIOD			
July 29, 2006	Total	Less than 1 Year	1–3 Years	3–5 Years	More than 5 Years
Operating leases	$ 1,215	$ 233	$ 280	$ 196	$ 506
Purchase commitments with contract manufacturers and suppliers	1,979	1,979	—	—	—
Purchase obligations	1,418	994	314	66	44
Long-term debt	6,505	—	502	3,003	3,000
Other long-term liabilities	161	10	80	28	43
Total	$11,278	$3,216	$1,176	$3,293	$ 3,593

		PAYMENTS DUE BY PERIOD			
July 30, 2005	Total	Less than 1 Year	1–3 Years	3–5 Years	More than 5 Years
Operating leases	$ 1,260	$ 215	$ 281	$ 184	$ 580
Purchase commitments with contract manufacturers and suppliers	954	954	—	—	—
Purchase obligations	1,398	1,014	338	46	—
Total	$ 3,612	$ 2,183	$ 619	$ 230	$ 580

Operating Leases We lease office space in several U.S. locations. Outside the United States, larger sites include Australia, Belgium, Canada, China, France, Germany, India, Italy, Japan, and the United Kingdom. Operating lease amounts include future minimum lease payments under all our noncancelable operating leases with an initial term in excess of one year.

Purchase Commitments with Contract Manufacturers and Suppliers We purchase components from a variety of suppliers and use several contract manufacturers to provide manufacturing services for our products. During the normal course of business, in order to manage manufacturing lead times and help ensure adequate component supply, we enter into agreements with contract manufacturers and suppliers that either allow them to procure inventory based upon criteria as defined by us or that establish the parameters defining our requirements. In certain instances, these agreements allow us the option to cancel, reschedule, and adjust our requirements based on our business needs prior to firm orders being placed. Consequently, only a portion of our reported purchase commitments arising from these agreements are firm, noncancelable, and unconditional commitments. The purchase commitments for inventory are expected to be fulfilled within one year. The increase in purchase commitments for inventory is related to the inclusion of approximately $295 million of purchase commitments for Scientific-Atlanta, the implementation of the lean manufacturing model, higher backlog, and longer lead times in the broader supply chain.

In addition to the above, we record a liability for firm, noncancelable, and unconditional purchase commitments for quantities in excess of our future demand forecasts consistent with our allowance for inventory. As of July 29, 2006, the liability for these purchase commitments was $148 million, compared with $87 million as of July 30, 2005. These amounts are included in other accrued liabilities in our Consolidated Balance Sheets at July 29, 2006 and July 30, 2005, and are not included in the preceding table.

Purchase Obligations Purchase obligations represent an estimate of all open purchase orders and contractual obligations in the ordinary course of business, other than commitments with contract manufacturers and suppliers, for which we have not received the goods or services. Although open purchase orders are considered enforceable and legally binding, the terms generally allow us the option to cancel, reschedule, and adjust our requirements based on our business needs prior to the delivery of goods or performance of services.

Other Long-Term Liabilities Our long-term liabilities consist of the fair value of interest rate swaps, accrued liability for defined benefit and deferred compensation plans, deferred tax liabilities, and other long-term liabilities. The future payments related to the fair value of interest rate swaps, deferred tax liabilities, and certain other long-term liabilities have not been presented in the table above due to the uncertainty regarding the timing of future payments with respect to these liabilities.

Other Commitments

We have entered into an agreement to invest approximately $800 million in venture funds managed by SOFTBANK Corp. and its affiliates ("SOFTBANK") that are required to be funded on demand. The total commitment is to be invested in venture funds and as senior debt with entities as directed by SOFTBANK. Our commitment to fund the senior debt is contingent upon the achievement of certain agreed-upon milestones. As of July 29, 2006, we had invested $523 million in the venture funds pursuant to the commitment, compared with $414 million as of July 30, 2005. In addition, as of July 29, 2006, we had invested $49 million in the senior debt pursuant to the commitment, all of which has been repaid. As of July 30, 2005, we had invested $49 million in the senior debt pursuant to the commitment, of which $47 million had been repaid.

We also have certain other funding commitments related to our privately held investments that are based on the achievement of certain agreed-upon milestones. The funding commitments were approximately $34 million as of July 29, 2006, compared with approximately $56 million as of July 30, 2005.

Off-Balance Sheet Arrangements

We consider our investments in unconsolidated variable interest entities to be off-balance sheet arrangements. In the ordinary course of business, we have investments in privately held companies and provide financing to certain customers through our wholly owned subsidiaries, which may be considered to be variable interest entities. We have evaluated our investments in these privately held companies and customer financings and have determined that there were no significant unconsolidated variable interest entities as of July 29, 2006.

Certain events can require a reassessment of our investments in privately held companies or customer financings to determine if they are variable interest entities and if we would be regarded as the primary beneficiary. As a result of such events, we may be required to make additional disclosures or consolidate these entities. Because we may not control these entities, we may not have the ability to influence these events.

Stock Repurchase Program

In September 2001, our Board of Directors authorized a stock repurchase program. As of July 29, 2006, our Board of Directors had authorized an aggregate repurchase of up to $40 billion of common stock under this program. During fiscal 2006, we repurchased and retired 435 million shares of our common stock at an average price of $19.07 per share for an aggregate purchase price of $8.3 billion. As of July 29, 2006, we have repurchased and retired 1.9 billion shares of our common stock at an average price of $18.36 per share for an aggregate purchase price of $35.4 billion since inception of the stock repurchase program, and the remaining authorized amount under the stock repurchase program was $4.6 billion with no termination date.

The purchase price for the shares of our common stock repurchased was reflected as a reduction to shareholders' equity. In accordance with Accounting Principles Board Opinion No. 6, "Status of Accounting Research Bulletins," we are required to allocate the purchase price of the repurchased shares as (i) a reduction to retained earnings until retained earnings are zero and then as an increase to accumulated deficit and (ii) a reduction of common stock and additional paid-in capital. Issuance of common stock and the tax benefit related to employee stock option plans are recorded as an increase to common stock and additional paid-in capital. As a result of future repurchases, we may continue to report an accumulated deficit included in shareholders' equity in our Consolidated Balance Sheets. Our accumulated deficit as of July 29, 2006 is a result of the accounting effect of stock repurchases and is not reflective of our financial performance or our liquidity.

Liquidity and Capital Resource Requirements

Based on past performance and current expectations, we believe our cash and cash equivalents, investments, and cash generated from operations will satisfy our working capital needs, capital expenditures, investment requirements, stock repurchases, contractual obligations, commitments (see Note 8 to the Consolidated Financial Statements), future customer financings, and other liquidity requirements associated with our operations through at least the next 12 months. We believe that the most strategic uses of our cash resources include repurchase of shares, strategic investments to gain access to new technologies, acquisitions, financing activities, and working capital. There are no other transactions, arrangements, or other relationships with unconsolidated entities or other persons that are reasonably likely to materially affect liquidity or the availability of our requirements for capital resources.

Quantitative and Qualitative Disclosures About Market Risk

Investments

We maintain an investment portfolio of various holdings, types, and maturities. See Note 6 to the Consolidated Financial Statements. These securities are classified as available-for-sale and consequently are recorded in the Consolidated Balance Sheets at fair value with unrealized gains or losses, to the extent unhedged, reported as a separate component of accumulated other comprehensive income, net of tax.

Fixed Income Securities

At any time, a sharp rise in interest rates could have a material adverse impact on the fair value of our fixed income investment portfolio. Conversely, declines in interest rates could have a material adverse impact on interest income for our investment portfolio. Our fixed income instruments are not leveraged as of July 29, 2006, and are held for purposes other than trading. The following tables present the hypothetical fair values of fixed income securities, including the effects of the interest rate swaps discussed further under "Interest Rate Derivatives" below, as a result of selected potential market decreases and increases in interest rates. Market changes reflect immediate hypothetical parallel shifts in the yield curve of plus or minus 50 basis points ("BPS"), 100 BPS, and 150 BPS. The hypothetical fair values as of July 29, 2006 and July 30, 2005 are as follows (in millions):

	VALUATION OF SECURITIES GIVEN AN INTEREST RATE DECREASE OF X BASIS POINTS			FAIR VALUE AS OF JULY 29, 2006	VALUATION OF SECURITIES GIVEN AN INTEREST RATE INCREASE OF X BASIS POINTS		
	(150 BPS)	(100 BPS)	(50 BPS)		50 BPS	100 BPS	150 BPS
U.S. government notes and bonds	$ 5,289	$ 5,238	$ 5,186	$ 5,135	$ 5,084	$ 5,032	$ 4,981
Corporate and municipal notes and bonds and asset-backed securities	8,772	8,738	8,705	8,670	8,636	8,603	8,568
Total	$14,061	$13,976	$13,891	$13,805	$13,720	$13,635	$13,549

	VALUATION OF SECURITIES GIVEN AN INTEREST RATE DECREASE OF X BASIS POINTS			FAIR VALUE AS OF JULY 30, 2005	VALUATION OF SECURITIES GIVEN AN INTEREST RATE INCREASE OF X BASIS POINTS		
	(150 BPS)	(100 BPS)	(50 BPS)		50 BPS	100 BPS	150 BPS
U.S. government notes and bonds	$ 3,540	$ 3,503	$ 3,467	$ 3,430	$ 3,393	$ 3,357	$ 3,320
Corporate and municipal notes and bonds and asset-backed securities	7,101	7,048	6,995	6,942	6,890	6,837	6,784
Total	$10,641	$10,551	$10,462	$ 10,372	$10,283	$10,194	$10,104

Publicly Traded Equity Securities

The values of our equity investments in several publicly traded companies are subject to market price volatility. The following tables present the hypothetical fair values of publicly traded equity securities as a result of selected potential decreases and increases in the price of each equity security in the portfolio, excluding hedged equity securities. Potential fluctuations in the price of each equity security in the portfolio of plus or minus 15%, 25%, and 35% were selected based on the probability of their occurrence. The hypothetical fair values as of July 29, 2006 and July 30, 2005 are as follows (in millions):

	VALUATION OF SECURITIES GIVEN AN X% DECREASE IN EACH STOCK'S PRICE			FAIR VALUE AS OF JULY 29, 2006	VALUATION OF SECURITIES GIVEN AN X% INCREASE IN EACH STOCK'S PRICE		
	(35%)	(25%)	(15%)		15%	25%	35%
Publicly traded equity securities	$ 421	$ 486	$ 551	$ 648	$ 745	$ 810	$ 875

	VALUATION OF SECURITIES GIVEN AN X% DECREASE IN EACH STOCK'S PRICE			FAIR VALUE AS OF JULY 30, 2005	VALUATION OF SECURITIES GIVEN AN X% INCREASE IN EACH STOCK'S PRICE		
	(35%)	(25%)	(15%)		15%	25%	35%
Publicly traded equity securities	$ 498	$ 575	$ 651	$ 766	$ 881	$ 958	$ 1,034

Quantitative and Qualitative Disclosures About Market Risk

Our equity portfolio consists of securities with characteristics that most closely match the Standard & Poor's 500 Index or NASDAQ Composite Index. These equity securities are held for purposes other than trading. Our impairment charge on certain publicly traded equity securities was $5 million during fiscal 2005. The impairment charge was related to the decline in the fair value of certain publicly traded equity securities below their cost basis that were judged to be other-than-temporary. There were no impairment charges on publicly traded equity securities in fiscal 2006 or fiscal 2004.

Investments in Privately Held Companies

We have invested in privately held companies, some of which are in the startup or development stages. These investments are inherently risky because the markets for the technologies or products these companies are developing are typically in the early stages and may never materialize. We could lose our entire initial investment in these companies. These investments are primarily carried at cost, which as of July 29, 2006 was $574 million, compared with $421 million at July 30, 2005, and are recorded in other assets in the Consolidated Balance Sheets. Our impairment charges on investments in privately held companies were $15 million, $39 million, and $112 million during fiscal 2006, 2005, and 2004, respectively.

Our evaluation of investments in private and public companies is based on the fundamentals of the businesses, including, among other factors, the nature of their technologies and potential for financial return.

Long-Term Debt

At any time, a sharp fall in interest rates could have a material adverse impact on the fair value of $6.0 billion of our fixed-rate debt. Conversely, a sharp rise in interest rates could have a material favorable impact. We have entered into $6.0 billion notional amount of interest rate swaps designated as fair value hedges, and gains and losses in the fair value of these swaps offset changes in the fair value of the fixed-rate debt. In effect, these swaps convert the fixed interest rates to floating interest rates based on LIBOR. A sharp change in rates would not have a material impact on the fair value of our $500 million variable-rate debt.

A sharp rise in short-term interest rates could have a material adverse impact on interest expense, while a sharp fall in short-term rates could have a material favorable impact. To mitigate these impacts, we presently invest a portion of our interest-bearing assets in instruments with similar interest rate characteristics as the swapped debt.

Derivative Instruments

Foreign Currency Derivatives

We enter into foreign exchange forward contracts to reduce the short-term effects of foreign currency fluctuations on receivables, investments, and payables, primarily denominated in Australian, Canadian, Japanese, and several European currencies, including the euro and British pound. Our market risks associated with our foreign currency receivables, investments, and payables relate primarily to variances from our forecasted foreign currency transactions and balances.

Approximately 75% of our operating expenses are U.S.-dollar denominated. To reduce variability in operating expenses caused by the remaining non-U.S.-dollar denominated operating expenses, we periodically hedge certain foreign currency forecasted transactions with currency options and forward contracts with maturities up to 18 months. These hedging programs are not designed to provide foreign currency protection over longer time horizons. In designing a specific hedging approach, we consider several factors, including offsetting exposures, significance of exposures, costs associated with entering into a particular hedge instrument, and potential effectiveness of the hedge. The gains and losses on foreign exchange contracts mitigate the variability in operating expenses associated with currency movements. Primarily because of our limited currency exposure to date, the effect of foreign currency fluctuations has not been material to our Consolidated Financial Statements. The effect of foreign currency fluctuations, net of hedging, decreased total research and development, sales and marketing, and general and administrative expenses by approximately 0.5% in fiscal 2006 compared with fiscal 2005 and increased total research and development, sales and marketing, and general and administrative expenses by approximately 2% in fiscal 2005 compared with fiscal 2004. The impact of foreign currency fluctuations on sales has not been material because our sales are primarily denominated in U.S. dollars.

Quantitative and Qualitative Disclosures About Market Risk

Foreign exchange forward and option contracts as of July 29, 2006 and July 30, 2005 are summarized as follows (in millions):

July 29, 2006	Notional Amount	Fair Value
Forward contracts:		
Purchased	**$1,376**	**$ (2)**
Sold	**$ 554**	**$ (3)**
Option contracts:		
Purchased	**$ 591**	**$20**
Sold	**$ 573**	**$ (2)**

July 30, 2005	Notional Amount	Fair Value
Forward contracts:		
Purchased	$ 1,011	$ (5)
Sold	$ 450	$ 9
Option contracts:		
Purchased	$ 1,028	$ 10
Sold	$ 1,002	$ (7)

Our foreign exchange forward contracts related to current assets and liabilities generally range from one to three months in original maturity. Additionally, we have entered into foreign exchange forward contracts related to long-term customer financings with maturities of up to two years. The foreign exchange forward contracts related to investments generally have maturities of less than one year. Currency option contracts generally have maturities of less than 18 months. We do not enter into foreign exchange forward and option contracts for trading purposes. We do not expect gains or losses on these derivative instruments to have a material impact on our financial results. See Note 8 to the Consolidated Financial Statements.

Interest Rate Derivatives

Our primary objective for holding fixed income securities is to achieve an appropriate investment return consistent with preserving principal and managing risk. To realize these objectives, we may utilize interest rate swaps or other derivatives designated as fair value or cash flow hedges. We have entered into $1.0 billion of interest rate swaps designated as fair value hedges of our investment portfolio. Under these interest rate swap contracts, we make fixed-rate interest payments and receive interest payments based on LIBOR. The effect of these swaps is to convert fixed-rate returns to floating-rate returns based on LIBOR for a portion of our fixed income portfolio. The gains and losses related to changes in the value of the interest rate swaps are included in other income, net, in the Consolidated Statements of Operations and offset the changes in fair value of the underlying hedged investment. As of July 29, 2006 and July 30, 2005, the fair values of the interest rate swaps designated as hedges of our investments were $45 million and $15 million, respectively, and were reflected in prepaid expenses and other current assets in the Consolidated Balance Sheets.

In conjunction with our issuance of fixed-rate senior notes in February 2006, we entered into $6.0 billion of interest rate swaps designated as fair value hedges of our fixed-rate debt. Under these interest rate swap contracts, we receive fixed-rate interest payments and make interest payments based on LIBOR. The effect of these swaps is to convert fixed-rate interest expense to floating-rate interest expense based on LIBOR. The gains and losses related to changes in the value of the interest rate swaps are included in other income, net, in the Consolidated Statements of Operations and offset the changes in fair value of the underlying debt. As of July 29, 2006, the fair value of the interest rate swaps designated as hedges of our debt was $155 million and was reflected in other long-term liabilities in the Consolidated Balance Sheets.

Equity Derivatives

We maintain a portfolio of publicly traded equity securities which are subject to price risk. We may hold equity securities for strategic purposes or to diversify our overall investment portfolio. To manage our exposure to changes in the fair value of certain equity securities, we may, from time to time, enter into equity derivative contracts. As of July 29,2006, we have entered into forward sale and option agreements on certain publicly traded equity securities designated as fair value hedges. The gains and losses due to changes in the value of the hedging instruments are included in other income, net, in the Consolidated Statements of Operations and offset the change in the fair value of the underlying hedged investment. As of July 29, 2006, the notional and fair value amounts of the derivatives were $164 million and $93 million, respectively. As of July 30, 2005, the notional and fair value amounts of the derivatives were $198 million and $19 million, respectively.

Consolidated Statements of Operations
(in millions, except per-share amounts)

Years Ended	July 29, 2006	July 30, 2005	July 31, 2004
NET SALES:			
Product	$23,917	$20,853	$18,550
Service	4,567	3,948	3,495
Total net sales	28,484	24,801	22,045
COST OF SALES:			
Product	8,114	6,758	5,766
Service	1,623	1,372	1,153
Total cost of sales	9,737	8,130	6,919
GROSS MARGIN	18,747	16,671	15,126
OPERATING EXPENSES:			
Research and development	4,067	3,322	3,192
Sales and marketing	6,031	4,721	4,530
General and administrative	1,169	959	867
Amortization of purchased intangible assets	393	227	242
In-process research and development	91	26	3
Total operating expenses	11,751	9,255	8,834
OPERATING INCOME	6,996	7,416	6,292
Interest income, net	607	552	512
Other income, net	30	68	188
Interest and other income, net	637	620	700
INCOME BEFORE PROVISION FOR INCOME TAXES AND CUMULATIVE EFFECT OF ACCOUNTING CHANGE	7,633	8,036	6,992
Provision for income taxes	2,053	2,295	2,024
INCOME BEFORE CUMULATIVE EFFECT OF ACCOUNTING CHANGE	5,580	5,741	4,968
Cumulative effect of accounting change, net of tax	—	—	(567)
NET INCOME	$ 5,580	$ 5,741	$ 4,401
Income per share before cumulative effect of accounting change—basic	$ 0.91	$ 0.88	$ 0.73
Income per share before cumulative effect of accounting change—diluted	$ 0.89	$ 0.87	$ 0.70
Net income per share—basic	$ 0.91	$ 0.88	$ 0.64
Net income per share—diluted	$ 0.89	$ 0.87	$ 0.62
Shares used in per-share calculation—basic	6,158	6,487	6,840
Shares used in per-share calculation—diluted	6,272	6,612	7,057

Supplemental Information

Net income for fiscal 2006 included stock-based compensation expense under Statement of Financial Accounting Standards No. 123 (revised 2004), "Share-Based Payment," ("SFAS 123(R)") of $836 million, net of tax, which consisted of stock-based compensation expense of $756 million, net of tax, related to employee stock options and employee stock purchases and stock-based compensation expense of $80 million, net of tax, related to acquisitions and investments. Net income for fiscal 2005 and fiscal 2004 included stock-based compensation expense of $149 million and $241 million, respectively, net of tax, related to acquisitions and investments. There was no stock-based compensation expense related to employee stock options and employee stock purchases under Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation" ("SFAS 123"), in fiscal 2005 and fiscal 2004 because the Company did not adopt the recognition provisions of SFAS 123. Net income including pro forma stock-based compensation expense as previously disclosed in the notes to the Consolidated Financial Statements for fiscal 2005 and fiscal 2004 was $4.7 billion or $0.71 per diluted share, and $3.2 billion or $0.45 per diluted share, respectively. See Note 10 to the Consolidated Financial Statements for additional information.

See Notes to Consolidated Financial Statements.

Consolidated Balance Sheets
(in millions, except par value)

	July 29, 2006	July 30, 2005
ASSETS		
Current assets:		
Cash and cash equivalents	$ 3,297	$ 4,742
Investments	14,517	11,313
Accounts receivable, net of allowance for doubtful accounts of $175 at July 29, 2006 and $162 at July 30, 2005	3,303	2,216
Inventories	1,371	1,297
Deferred tax assets	1,604	1,475
Prepaid expenses and other current assets	1,584	967
Total current assets	25,676	22,010
Property and equipment, net	3,440	3,320
Goodwill	9,227	5,295
Purchased intangible assets, net	2,161	549
Other assets	2,811	2,709
TOTAL ASSETS	$43,315	$ 33,883
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 880	$ 735
Income taxes payable	1,744	1,511
Accrued compensation	1,516	1,317
Deferred revenue	4,408	3,854
Other accrued liabilities	2,765	2,094
Total current liabilities	11,313	9,511
Long-term debt	6,332	—
Deferred revenue	1,241	1,188
Other long-term liabilities	511	—
Total liabilities	19,397	10,699
Commitments and contingencies (Note 8)		
Minority interest	6	10
Shareholders' equity:		
Preferred stock, no par value: 5 shares authorized; none issued and outstanding	—	—
Common stock and additional paid-in capital, $0.001 par value: 20,000 shares authorized; 6,059 and 6,331 shares issued and outstanding at July 29, 2006 and July 30, 2005, respectively	24,257	22,394
Retained earnings (Accumulated deficit)	(617)	506
Accumulated other comprehensive income	272	274
Total shareholders' equity	23,912	23,174
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	$43,315	$ 33,883

See Notes to Consolidated Financial Statements.

Consolidated Statements of Cash Flows
(in millions)

Years Ended	July 29, 2006	July 30, 2005	July 31, 2004
Cash flows from operating activities:			
Net income	$ 5,580	$ 5,741	$ 4,401
Adjustments to reconcile net income to net cash provided by operating activities:			
Cumulative effect of accounting change, net of tax	—	—	567
Depreciation and amortization	1,293	1,020	1,199
Stock-based compensation expense related to employee stock options and employee stock purchases	1,050	—	—
Stock-based compensation expense related to acquisitions and investments	87	154	244
Provision for doubtful accounts	24	—	19
Provision for inventory	162	221	205
Deferred income taxes	(343)	55	552
Tax benefits from employee stock option plans	—	35	537
Excess tax benefits from stock-based compensation	(432)	—	—
In-process research and development	91	26	3
Net gains and impairment charges on investments	(124)	(95)	(155)
Other	31	—	—
Change in operating assets and liabilities, net of effects of acquisitions:			
Accounts receivable	(913)	(373)	(488)
Inventories	(41)	(305)	(538)
Prepaid expenses and other current assets	(300)	(58)	(42)
Lease receivables, net	(171)	(163)	(159)
Accounts payable	(43)	62	54
Income taxes payable	743	947	260
Accrued compensation	150	(154)	(7)
Deferred revenue	575	541	688
Other liabilities	480	(86)	(378)
Net cash provided by operating activities	7,899	7,568	6,962
Cash flows from investing activities:			
Purchases of investments	(21,732)	(20,314)	(33,054)
Proceeds from sales and maturities of investments	18,480	24,630	34,327
Acquisition of property and equipment	(772)	(692)	(613)
Acquisition of businesses, net of cash and cash equivalents acquired	(5,399)	(911)	(104)
Change in investments in privately held companies	(186)	(171)	(13)
Purchase of minority interest of Cisco Systems, K.K. (Japan)	(25)	(34)	(71)
Other	(10)	106	153
Net cash (used in) provided by investing activities	(9,644)	2,614	625
Cash flows from financing activities:			
Issuance of common stock	1,682	1,087	1,257
Repurchase of common stock	(8,295)	(10,235)	(9,080)
Issuance of debt	6,481	—	—
Excess tax benefits from stock-based compensation	432	—	—
Other	—	(14)	33
Net cash provided by (used in) financing activities	300	(9,162)	(7,790)
Net (decrease) increase in cash and cash equivalents	(1,445)	1,020	(203)
Cash and cash equivalents, beginning of fiscal year	4,742	3,722	3,925
Cash and cash equivalents, end of fiscal year	$ 3,297	$ 4,742	$ 3,722

See Notes to Consolidated Financial Statements.

Consolidated Statements of Shareholders' Equity
(in millions)

	Shares of Common Stock	Common Stock and Additional Paid-In Capital	Retained Earnings (Accumulated Deficit)	Accumulated Other Comprehensive Income	Total Shareholders' Equity
BALANCE AT JULY 26, 2003	6,998	$ 21,116	$ 6,559	$ 354	$ 28,029
Net income	—	—	4,401	—	4,401
Change in unrealized gains and losses on investments, net of tax	—	—	—	(161)	(161)
Other	—	—	—	19	19
Comprehensive income					4,259
Issuance of common stock	122	1,257	—	—	1,257
Repurchase of common stock	(408)	(1,284)	(7,796)	—	(9,080)
Tax benefits from employee stock option plans	—	537	—	—	537
Purchase acquisitions	—	6	—	—	6
Stock-based compensation expense related to acquisitions and investments	—	244	—	—	244
Cumulative effect of accounting change, net of tax	—	567	—	—	567
Acquisition of Andiamo Systems, Inc.	23	7	—	—	7
BALANCE AT JULY 31, 2004	6,735	$ 22,450	$ 3,164	$ 212	$ 25,826
Net income	—	—	5,741	—	5,741
Change in unrealized gains and losses on investments, net of tax	—	—	—	52	52
Other	—	—	—	10	10
Comprehensive income					5,803
Issuance of common stock	112	1,087	—	—	1,087
Repurchase of common stock	(540)	(1,836)	(8,399)	—	(10,235)
Tax benefits from employee stock option plans	—	35	—	—	35
Purchase acquisitions	24	504	—	—	504
Stock-based compensation expense related to acquisitions and investments	—	154	—	—	154
BALANCE AT JULY 30, 2005	6,331	$ 22,394	$ 506	$ 274	$ 23,174
Net income	—	—	5,580	—	5,580
Change in unrealized gains and losses on investments, net of tax	—	—	—	(63)	(63)
Other	—	—	—	61	61
Comprehensive income					5,578
Issuance of common stock	162	1,682	—	—	1,682
Repurchase of common stock	(435)	(1,592)	(6,703)	—	(8,295)
Tax benefits from employee stock option plans	—	454	—	—	454
Purchase acquisitions	1	188	—	—	188
Stock-based compensation expense related to employee stock options and employee stock purchases	—	1,044	—	—	1,044
Stock-based compensation expense related to acquisitions and investments	—	87	—	—	87
BALANCE AT JULY 29, 2006	6,059	$ 24,257	$ (617)	$ 272	$ 23,912

Supplemental Information

In September 2001, the Company's Board of Directors authorized a stock repurchase program. As of July 29, 2006, the Company's Board of Directors has authorized an aggregate repurchase of up to $40 billion of common stock under this program. For additional information regarding stock repurchases, see Note 9 to the Consolidated Financial Statements. The purchase price of shares of common stock repurchased was reflected as (i) a reduction to retained earnings until retained earnings are zero and then as an increase to accumulated deficit and (ii) a reduction of common stock and additional paid-in capital. Issuance of common stock and the tax benefit related to employee stock option plans are recorded in shareholders' equity as an increase to common stock and additional paid-in capital. The stock repurchases since the inception of this program are summarized in the table below (in millions):

	Shares of Common Stock	Common Stock and Additional Paid-In Capital	Retained Earnings (Accumulated Deficit)	Accumulated Other Comprehensive Income	Total Shareholders' Equity
Repurchases of common stock	1,931	$6,294	$29,154	$ —	$35,448

See Notes to Consolidated Financial Statements.

Notes to Consolidated Financial Statements

1. Description of Business

Cisco Systems, Inc. (the "Company" or "Cisco") designs, manufactures, and sells networking and other products related to the communications and information technology industry and provides services associated with these products and their use. The Company's products are installed at corporations, public institutions, telecommunications companies, and commercial businesses and are also found in personal residences. Cisco provides a broad line of products for transporting data, voice, and video within buildings, across campuses, and around the world.

On February 24, 2006, the Company completed the acquisition of Scientific-Atlanta, Inc. ("Scientific-Atlanta"), a provider of set-top boxes, end-to-end video distribution networks, and video system integration. With this acquisition, the Company has added video to the convergence of data, voice, and mobility technologies, which enables the Company to be a stronger strategic business partner with its service provider customers, as well as reach a broad range of consumers with its products.

2. Summary of Significant Accounting Policies

Fiscal Year The Company's fiscal year is the 52 or 53 weeks ending on the last Saturday in July. Fiscal 2006 and 2005 were 52-week fiscal years, and fiscal 2004 was a 53-week fiscal year.

Principles of Consolidation The Consolidated Financial Statements include the accounts of Cisco Systems, Inc. and its subsidiaries. All significant intercompany accounts and transactions have been eliminated.

Cash and Cash Equivalents The Company considers all highly liquid investments purchased with an original or remaining maturity of less than three months at the date of purchase to be cash equivalents. Cash and cash equivalents are maintained with various financial institutions.

Investments The Company's investments comprise U.S. government notes and bonds; corporate notes, bonds, and asset-backed securities; municipal notes and bonds; and publicly traded equity securities. These investments are held in the custody of several major financial institutions. The specific identification method is used to determine the cost basis of fixed income securities disposed of. The weighted-average method is used to determine the cost basis of publicly traded equity securities disposed of. At July 29, 2006 and July 30, 2005, the Company's investments were classified as available-for-sale. These investments are recorded in the Consolidated Balance Sheets at fair value. Unrealized gains and losses on these investments, to the extent the investments are unhedged, are included as a separate component of accumulated other comprehensive income, net of tax.

Effective October 29, 2005 the Company changed the method of classification of its investments previously classified as long-term investments to current assets and the balances for the prior years have been reclassified to conform to the current year's presentation. This new method classifies these securities as current or long-term based on the nature of the securities and the availability for use in current operations while the prior classification was based on the maturities of the investments. The Company believes this method is preferable because it is more reflective of the Company's assessment of its overall liquidity position. In conjunction with this change in classification of investments, the Company changed the classification of deferred taxes related to the unrealized gains and losses on long-term investments from noncurrent assets to current assets.

The Company recognizes an impairment charge when a decline in the fair value of its investments below the cost basis is judged to be other-than-temporary. The Company considers various factors in determining whether to recognize an impairment charge, including the length of time and extent to which the fair value has been less than the Company's cost basis, the financial condition and near-term prospects of the investee, and the Company's intent and ability to hold the investment for a period of time sufficient to allow for any anticipated recovery in market value.

The Company also has investments in privately held companies. These investments are included in other assets in the Consolidated Balance Sheets and are primarily carried at cost. The Company monitors these investments for impairment and makes appropriate reductions in carrying values if the Company determines that an impairment charge is required based primarily on the financial condition and near-term prospects of these companies.

Inventories Inventories are stated at the lower of cost or market. Cost is computed using standard cost, which approximates actual cost, on a first-in, first-out basis. The Company provides inventory allowances based on excess and obsolete inventories determined primarily by future demand forecasts. The allowance is measured as the difference between the cost of the inventory and market based upon assumptions about future demand and charged to the provision for inventory, which is a component of cost of sales. At the point of the loss recognition, a new, lower-cost basis for that inventory is established, and subsequent changes in facts and circumstances do not result in the restoration or increase in that newly established cost basis. In addition, the Company records a liability for firm, noncancelable, and unconditional purchase commitments with contract manufacturers and suppliers for quantities in excess of the Company's future demand forecasts consistent with its allowance for inventory.

Fair Value of Financial Instruments The fair value of certain of the Company's financial instruments, including cash and cash equivalents, accrued compensation, and other accrued liabilities, approximate cost because of their short maturities. The fair values of investments and the Company's long-term debt are determined using quoted market prices for those securities or similar financial instruments.

Concentrations of Risk Cash and cash equivalents are maintained with several financial institutions. Deposits held with banks may exceed the amount of insurance provided on such deposits. Generally, these deposits may be redeemed upon demand and are maintained with financial institutions of reputable credit and therefore bear minimal credit risk.

The Company performs ongoing credit evaluations of its customers and, with the exception of certain financing transactions, does not require collateral from its customers. The Company's customers are primarily in the enterprise, service provider and commercial markets. The Company receives certain of its components from sole suppliers. Additionally, the Company relies on a limited number of contract manufacturers and suppliers to provide manufacturing services for its products. The inability of a contract manufacturer or supplier to fulfill supply requirements of the Company could materially impact future operating results.

Revenue Recognition The Company's products are generally integrated with software that is essential to the functionality of the equipment. Additionally, the Company provides unspecified software upgrades and enhancements related to the equipment through its maintenance contracts for most of its products. Accordingly, the Company accounts for revenue in accordance with Statement of Position No. 97-2, "Software Revenue Recognition," and all related interpretations. For sales of products where software is incidental to the equipment, the Company applies the provisions of Staff Accounting Bulletin No. 101, "Revenue Recognition in Financial Statements" and Staff Accounting Bulletin No. 104, "Revenue Recognition," and all related interpretations.

The Company recognizes revenue when persuasive evidence of an arrangement exists, delivery has occurred, the fee is fixed or determinable, and collectibility is reasonably assured. In instances where final acceptance of the product, system, or solution is specified by the customer, revenue is deferred until all acceptance criteria have been met. Technical support services revenue is deferred and recognized ratably over the period during which the services are to be performed, which is typically from one to three years. Advanced services revenue is recognized upon delivery or completion of performance.

When a sale involves multiple elements, such as sales of products that include services, the entire fee from the arrangement is allocated to each respective element based on its relative fair value and recognized when revenue recognition criteria for each element are met. Fair value for each element is established based on the sales price charged when the same element is sold separately.

The Company uses distributors that stock inventory and typically sell to systems integrators, service providers, and other resellers. In addition, certain products are sold through retail partners. The Company refers to these sales through distributors and retail partners as its two-tier system of sales to the end customer. Revenue from distributors and retail partners is recognized based on a sell-through method using information provided by them. Distributors and retail partners participate in various cooperative marketing and other programs, and the Company maintains estimated accruals and allowances for these programs. The Company accrues for warranty costs, sales returns, and other allowances based on its historical experience.

Allowance for Doubtful Accounts The allowance for doubtful accounts is based on the Company's assessment of the collectibility of customer accounts. The Company regularly reviews the allowance by considering factors such as historical experience, credit quality, the age of the accounts receivable balances, and current economic conditions that may affect a customer's ability to pay.

Lease Receivables The Company provides a variety of lease financing services to its customers to build, maintain, and upgrade their networks. Lease receivables primarily represent the principal balance remaining in sales-type and direct-financing leases under these programs, net of allowances. These leases typically have two- to three-year terms and are usually collateralized by a security interest in the underlying assets.

Advertising Costs The Company expenses all advertising costs as incurred, and the amounts were not material for all years presented.

Software Development Costs Software development costs required to be capitalized pursuant to Statement of Financial Accounting Standards No. 86, "Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed," have not been material to date. Software development costs for internal use required to be capitalized pursuant to Statement of Position No. 98-1, "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use," have also not been material to date.

Depreciation and Amortization Property and equipment are stated at cost, less accumulated depreciation and amortization. Depreciation and amortization are computed using the straight-line method over the estimated useful lives of the assets. Estimated useful lives of 25 years are used for buildings. Estimated useful lives of 30 to 36 months are used for computer equipment and related software and five years for furniture and fixtures. Estimated useful lives of up to five years are used for production, engineering, and other equipment. Depreciation of operating lease assets is computed based on the respective lease terms, which generally range up to three years. Depreciation and amortization of leasehold improvements are computed using the shorter of the remaining lease terms or five years.

Goodwill and Purchased Intangible Assets Goodwill is tested for impairment on an annual basis and between annual tests in certain circumstances, and written down when impaired. Based on the impairment tests performed, there was no impairment of goodwill in fiscal 2006, 2005, or 2004. Purchased intangible assets other than goodwill are amortized over their useful lives unless these lives are determined to be indefinite. Purchased intangible assets are carried at cost, less accumulated amortization. Amortization is computed over the estimated useful lives of the respective assets, generally two to seven years.

Impairment of Long-Lived Assets Long-lived assets and certain identifiable intangible assets to be held and used are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of such assets may not be recoverable. Determination of recoverability of long-lived assets is based on an estimate of undiscounted future cash flows resulting from the use of the asset and its eventual disposition. Measurement of an impairment loss for long-lived assets and certain identifiable intangible assets that management expects to hold and use is based on the fair value of the asset. Long-lived assets and certain identifiable intangible assets to be disposed of are reported at the lower of carrying amount or fair value less costs to sell.

Income Taxes Income tax expense is based on pretax financial accounting income. Deferred tax assets and liabilities are recognized for the expected tax consequences of temporary differences between the tax bases of assets and liabilities and their reported amounts. Valuation allowances are recorded to reduce deferred tax assets to the amount that will more likely than not be realized.

Computation of Net Income per Share Basic net income per share is computed using the weighted-average number of common shares outstanding during the period. Diluted net income per share is computed using the weighted-average number of common shares and dilutive potential common shares outstanding during the period. Dilutive potential common shares primarily consist of employee stock options and restricted common stock.

Statement of Financial Accounting Standards No. 128, "Earnings per Share," requires that employee equity share options, nonvested shares, and similar equity instruments granted by the Company be treated as potential common shares outstanding in computing diluted earnings per share. Diluted shares outstanding include the dilutive effect of in-the-money options which is calculated based on the average share price for each fiscal period using the treasury stock method. Under the treasury stock method, the amount the employee must pay for exercising stock options, the amount of compensation cost for future service that the Company has not yet recognized, and the amount of tax benefits that would be recorded in additional paid-in capital when the award becomes deductible are assumed to be used to repurchase shares.

Foreign Currency Translation Assets and liabilities of non-U.S. subsidiaries that operate in a local currency environment, where that local currency is the functional currency, are translated to U.S. dollars at exchange rates in effect at the balance sheet date, with the resulting translation adjustments directly recorded to a separate component of accumulated other comprehensive income. Income and expense accounts are translated at average exchange rates during the year. Translation adjustments are recorded in other income, net, where the U.S. dollar is the functional currency.

Derivative Instruments The Company recognizes derivative instruments as either assets or liabilities in the Consolidated Balance Sheets and measures those instruments at fair value. The accounting for changes in the fair value of a derivative depends on the intended use of the derivative and the resulting designation. For a derivative instrument designated as a fair value hedge, the gain or loss is recognized in earnings in the period of change together with the offsetting loss or gain on the hedged item attributed to the risk being hedged. For a derivative instrument designated as a cash flow hedge, the effective portion of the derivative's gain or loss is initially reported as a component of accumulated other comprehensive income and subsequently reclassified into earnings when the hedged exposure affects earnings. The ineffective portion of the gain or loss is reported in earnings immediately. For derivative instruments that are not designated as accounting hedges, changes in fair value are recognized in earnings in the period of change. During fiscal 2006, 2005, and 2004, there were no significant gains or losses recognized in earnings for hedge ineffectiveness. The Company did not discontinue any hedges because it was probable that the original forecasted transactions would not occur.

Consolidation of Variable Interest Entities FASB Interpretation No. 46, "Consolidation of Variable Interest Entities" ("FIN 46"), was issued in January 2003. FIN 46 requires that if an entity is the primary beneficiary of a variable interest entity, the assets, liabilities, and results of operations of the variable interest entity should be included in the consolidated financial statements of the entity. FASB Interpretation No. 46(R), "Consolidation of Variable Interest Entities" ("FIN 46(R)"), was issued in December 2003. The Company adopted FIN 46(R) effective January 24, 2004, and recorded a noncash cumulative stock compensation charge of $567 million, net of tax, relating to the consolidation of Andiamo Systems, Inc. ("Andiamo"). For additional information regarding Andiamo, see Note 3 to the Consolidated Financial Statements. For additional information regarding variable interest entities, see Note 8 to the Consolidated Financial Statements.

Minority Interest The Company consolidates its investment in a venture fund managed by SOFTBANK Corp. and its affiliates ("SOFTBANK"). As of July 29, 2006, minority interest of $6 million represents SOFTBANK's share of the venture fund.

Use of Estimates The preparation of financial statements and related disclosures in conformity with accounting principles generally accepted in the United States requires management to make estimates and judgments that affect the amounts reported in the Consolidated Financial Statements and accompanying notes. Estimates are used for revenue recognition, allowance for doubtful accounts and sales returns, allowance for inventory and liability for purchase commitments with contract manufacturers and suppliers, warranty costs, stock-based compensation expense, investment impairments, goodwill impairments, income taxes, and loss contingencies, among others. The actual results experienced by the Company may differ materially from management's estimates.

Stock-Based Compensation Expense On July 31, 2005, the Company adopted Statement of Financial Accounting Standards No. 123 (revised 2004), "Share-Based Payment," ("SFAS 123(R)") which requires the measurement and recognition of compensation expense for all share-based payment awards made to employees and directors including employee stock options and employee stock purchases related to the Employee Stock Purchase Plan ("employee stock purchases") based on estimated fair values. SFAS 123(R) supersedes the Company's previous accounting under Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB 25") beginning in fiscal 2006. In March 2005, the Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin No. 107 ("SAB 107") relating to SFAS 123(R). The Company has applied the provisions of SAB 107 in its adoption of SFAS 123(R).

The Company adopted SFAS 123(R) using the modified prospective transition method, which requires the application of the accounting standard as of July 31, 2005, the first day of the Company's fiscal year 2006. The Company's Consolidated Financial Statement for fiscal 2006 reflects the impact of SFAS 123(R). In accordance with the modified prospective transition method, the Company's Consolidated Financial Statements for prior fiscal years have not been restated to reflect, and do not include, the impact of SFAS 123(R). Stock-based compensation expense recognized under SFAS 123(R) for fiscal 2006 was $1.1 billion, which consisted of stock-based compensation expense related to employee stock options and employee stock purchases of $1.0 billion, and stock-based compensation expense related to acquisitions and investments of $87 million. For fiscal 2005 and fiscal 2004, stock-based compensation expense of $154 million and $244 million, respectively, was related to acquisitions and investments which the Company had been recognizing under previous accounting standards. There was no stock-based compensation expense related to employee stock options and employee stock purchases recognized during fiscal 2005 and fiscal 2004. See Note 10 to the Consolidated Financial Statements for additional information.

SFAS 123(R) requires companies to estimate the fair value of share-based payment awards on the date of grant using an option-pricing model. The value of awards that are ultimately expected to vest is recognized as expense over the requisite service periods in the Company's Consolidated Statements of Operations. Prior to the adoption of SFAS 123(R), the Company accounted for stock-based awards to employees and directors using the intrinsic value method in accordance with APB 25 as allowed under SFAS 123. Under the intrinsic value method, no stock-based compensation expense had been recognized in the Company's Consolidated Statement of Operations, other than as related to acquisitions and investments, because the exercise price of the Company's stock options granted to employees and directors equaled the fair market value of the underlying stock at the date of grant.

Stock-based compensation expense recognized in the Company's Consolidated Statement of Operations for fiscal 2006 included compensation expense for share-based payment awards granted prior to, but not yet vested as of July 30, 2005 based on the grant date fair value estimated in accordance with the pro forma provisions of SFAS 123 and compensation expense for the share-based payment awards granted subsequent to July 30, 2005 based on the grant date fair value estimated in accordance with the provisions of SFAS 123(R). In conjunction with the adoption of SFAS 123(R), the Company changed its method of attributing the value of stock-based compensation to expense from the accelerated multiple-option approach to the straight-line single-option method. Compensation expense for all share-based payment awards granted on or prior to July 30, 2005 will continue to be recognized using the accelerated multiple-option approach while compensation expense for all share-based payment awards granted subsequent to July 30, 2005 is recognized using the straight-line single-option method. Because stock-based compensation expense recognized in the Consolidated Statement of Operations for fiscal 2006 is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. In the Company's pro forma information required under SFAS 123 for the periods prior to fiscal 2006, the Company accounted for forfeitures as they occurred.

Upon adoption of SFAS 123(R), the Company also changed its method of valuation for share-based awards granted beginning in fiscal 2006 to a lattice-binomial option-pricing model ("lattice-binomial model") from the Black-Scholes option-pricing model ("Black-Scholes model") which was previously used for the Company's pro forma information required under SFAS 123. For additional information, see Note 10 to the Consolidated Financial Statements. The Company's determination of fair value of share-based payment awards on the date of grant using an option-pricing model is affected by the Company's stock price as well as assumptions regarding a number of highly complex and subjective variables. These variables include, but are not limited to, the Company's expected stock price volatility over the term of the awards, and actual and projected employee stock option exercise behaviors. Option-pricing models were developed for use in estimating the value of traded options that have no vesting or hedging restrictions and are fully transferable. Because the Company's employee stock options have certain characteristics that are significantly different from traded options, and because changes in the subjective assumptions can materially affect the estimated value, in management's opinion, the existing valuation models may not provide an accurate measure of the fair value of the Company's employee stock options. Although the fair value of employee stock options is determined in accordance with SFAS 123(R) and SAB 107 using an option-pricing model, that value may not be indicative of the fair value observed in a willing buyer/willing seller market transaction.

On November 10, 2005, the Financial Accounting Standards Board (FASB) issued FASB Staff Position No. FAS 123(R)-3 "Transition Election Related to Accounting for Tax Effects of Share-Based Payment Awards." The Company has elected to adopt the alternative transition method provided in the FASB Staff Position for calculating the tax effects of stock-based compensation pursuant to SFAS 123(R). The alternative transition method includes simplified methods to establish the beginning balance of the additional paid-in capital pool ("APIC pool") related to the tax effects of employee stock-based compensation, and to determine the subsequent impact on the APIC pool and Consolidated Statements of Cash Flows of the tax effects of employee stock-based compensation awards that are outstanding upon adoption of SFAS 123(R).

Recent Accounting Pronouncement In July 2006, the FASB issued Financial Interpretation No. 48, "Accounting for Uncertainty in Income Taxes-an interpretation of FASB Statement No. 109" ("FIN 48"), which is a change in accounting for income taxes. FIN 48 specifies how tax benefits for uncertain tax positions are to be recognized, measured, and derecognized in financial statements; requires certain disclosures of uncertain tax matters; specifies how reserves for uncertain tax positions should be classified on the balance sheet; and provides transition and interim period guidance, among other provisions. FIN 48 is effective for fiscal years beginning after December 15, 2006 and as a result, is effective for the Company in the first quarter of fiscal 2008. The Company is currently evaluating the impact of FIN 48 on its Consolidated Financial Statements.

Reclassifications Certain reclassifications have been made to prior year balances in order to conform to the current year's presentation.

3. Business Combinations

Acquisition of Scientific-Atlanta, Inc.

On February 24, 2006, Cisco completed the acquisition of Scientific-Atlanta, Inc., a provider of set-top boxes, end-to-end video distribution networks, and video system integration. Cisco believes video is emerging as the key strategic application in the service provider "triple play" bundle of consumer entertainment, communications, and online services. Cisco believes the combined entity creates an end-to-end solution for carrier networks and the digital home and delivers large-scale video systems to extend Cisco's commitment to and leadership in the service provider market.

Pursuant to the terms of the merger agreement, the Company paid a cash amount of $43.00 per share in exchange for each outstanding share of Scientific-Atlanta common stock and assumed each Scientific-Atlanta stock option which was outstanding immediately prior to the effective time of the merger. Each unvested Scientific-Atlanta stock option became fully vested immediately prior to the completion of the merger. The Scientific-Atlanta stock options assumed were converted into options to purchase an aggregate of approximately 32.1 million shares of Cisco common stock. The total purchase price was as follows (in millions):

	Amount
Cash	$6,907
Fair value of fully-vested Scientific-Atlanta, Inc. stock options assumed	163
Acquisition-related costs	17
Total	$7,087

The fair value of Scientific-Atlanta stock options assumed was determined using a lattice-binomial model. The use of the lattice-binomial model and method of determining the variables is consistent with the Company's valuation of stock options in accordance with SFAS 123(R). See Note 10 to the Consolidated Financial Statements. Under the purchase method of accounting, the total purchase price as shown in the table above is allocated to the tangible and identifiable intangible assets acquired and liabilities assumed based on their estimated fair values. The purchase price was allocated using the information currently available. As a result, the Company may continue to adjust the preliminary purchase price allocation after obtaining more information regarding, among other things, asset valuations, liabilities assumed, and revisions of preliminary estimates. The purchase price allocation will be finalized in fiscal 2007.

The Company allocated the purchase price to tangible assets, liabilities assumed, and identifiable intangible assets acquired, as well as in-process research and development, based on their estimated fair values. The excess of the purchase price over the aggregate fair values was recorded as goodwill. The fair value assigned to identifiable intangible assets acquired is determined using the income approach, which discounts expected future cash flows to present value using estimates and assumptions determined by management. The acquired goodwill was assigned to each of the reportable segments. Purchased intangibles are amortized on a straight-line basis over their respective useful lives. The total preliminary allocation of the purchase price as of July 29, 2006 is as follows (in millions):

	Amount
Cash and cash equivalents	$ 1,747
Investments	137
Accounts receivable	195
Inventories	191
Property and equipment, net	254
Goodwill	3,762
Purchased intangible assets	1,949
Other current and noncurrent assets	106
Accounts payable	(187)
Deferred revenue	(32)
Other liabilities	(478)
Deferred tax liabilities, net	(645)
In-process research and development	88
Total	$ 7,087

None of the goodwill recorded as part of the Scientific-Atlanta acquisition will be deductible for U.S. federal income tax purposes. Amortization of goodwill will be deductible for state income tax purposes in those states in which the Company elected to step up its basis in the acquired assets.

Intangible assets consist primarily of customer relationships, technology and other intangibles. The intangible assets attributable to customer relationships relate to Scientific-Atlanta's ability to sell existing, in-process, and future versions of its products to its existing customers. Technology intangibles include a combination of patented and unpatented technology, trade secrets, and computer software that represent the foundation for current and planned new products. The following table presents details of the purchased intangible assets acquired as part of the acquisition of Scientific-Atlanta (in millions, except years):

	Weighted-Average Useful Life (in Years)	Amount
Customer relationships	7.0	$ 1,346
Technology	3.5	546
Other	2.0	57
Total		$ 1,949

Unaudited Pro Forma Financial Information

The unaudited financial information in the table below summarizes the combined results of operations of Cisco and Scientific-Atlanta, on a pro forma basis, as though the companies had been combined as of the beginning of each of the fiscal years presented. The unaudited pro forma financial information for fiscal 2006 combines the results for Cisco for fiscal 2006, which include the results of Scientific-Atlanta subsequent to February 24, 2006, and the historical results for Scientific-Atlanta for the six months ended December 30, 2005 and the month ended February 24, 2006. The unaudited pro forma financial information for fiscal 2005 combines the historical results for Cisco for fiscal 2005, with the historical results for Scientific-Atlanta for its fiscal year ended July 1, 2005.

The pro forma financial information is presented for informational purposes only and is not indicative of the results of operations that would have been achieved if the acquisition of Scientific-Atlanta and issuance of $6.5 billion of debt (see Note 7 to the Consolidated Financial Statements) had taken place at the beginning of each of the fiscal years presented. The debt was issued to finance the acquisition of Scientific-Atlanta as well as for general corporate purposes. For the purposes of these unaudited pro forma combined financial statements, the entire debt and the related interest expense, including the effect of hedging, were included in the pro forma adjustments. The pro forma financial information for fiscal 2006 includes incremental stock-based compensation expense due to the acceleration of Scientific-Atlanta employee stock options prior to the acquisition of Scientific-Atlanta, investment banking fees, and other acquisition-related costs, recorded in Scientific-Atlanta's historical results of operations during February 2006. The pro forma financial information for each fiscal year presented also includes the purchase accounting adjustments on historical Scientific-Atlanta inventory, adjustments to depreciation on acquired property and equipment, a charge for in-process research and development, amortization charges from acquired intangible assets, adjustments to interest income and expense, and related tax effects. The following table summarizes the pro forma financial information (in millions, except per-share amounts):

Years Ended	July 29, 2006	July 30, 2005
Net sales	$29,632	$26,712
Net income	$ 5,366	$ 5,406
Net income per share—basic	$ 0.87	$ 0.83
Net income per share—diluted	$ 0.86	$ 0.82

Other Purchase Acquisitions

A summary of the purchase acquisitions and asset purchases in fiscal 2006 other than the Scientific-Atlanta acquisition is as follows (in millions):

	Shares Issued	Purchase Consideration	Liabilities Assumed	In-Process R&D Expense	Purchased Intangible Assets	Goodwill
KiSS Technology A/S	1	$ 51	$18	$ 2	$ 19	$ 39
Metreos Corporation	—	27	1	—	2	25
Sheer Networks, Inc.	—	96	7	—	29	56
SyPixx Networks, Inc.	—	37	3	—	12	29
Other	—	59	2	1	41	24
Total	1	$270	$31	$ 3	$ 103	$ 173

- Acquisition of KiSS Technology A/S to develop networked entertainment products for the consumer.
- Acquisition of Metreos Corporation to strengthen the Cisco Service-Oriented Network Architecture (SONA).
- Acquisition of Sheer Networks, Inc. to provide technology that is designed to adapt to network changes, scale to large networks, and help extend new technologies and services to simplify the task of monitoring and maintaining complex networks.
- Acquisition of SyPixx Networks, Inc. to further develop the Company's portfolio of physical security products.

Under the terms of the definitive agreements related to these acquisitions, the purchase consideration for the acquisitions in fiscal 2006 consisted of cash, shares of Cisco common stock, and fully-vested stock options assumed. The purchase consideration for the Company's acquisitions is also allocated to tangible assets acquired. A summary of the purchase acquisitions and asset purchases completed in fiscal 2005 and 2004 is as follows (in millions):

Fiscal 2005	Shares Issued	Purchase Consideration	Liabilities Assumed	In-Process R&D Expense	Purchased Intangible Assets	Goodwill
Actona Technologies, Inc.	—	$ 90	$ 4	$ 4	$ 21	$ 66
Airespace, Inc.	23	447	11	3	95	337
NetSolve, Incorporated	—	146	6	—	31	78
P-Cube Inc.	—	213	17	6	56	150
Procket Networks, Inc.	—	92	10	—	26	76
Topspin Communications, Inc.	—	253	23	4	67	164
Other	—	350	41	9	155	196
Total	23	$1,591	$112	$26	$451	$1,067

- Acquisition of Actona Technologies, Inc. to expand the functionality of its branch-office access routers with intelligent network services that are designed to allow users at remote sites to access and transfer files as quickly and easily as users at headquarters sites. The acquired technology is also designed to allow enterprises to centralize file servers and storage and better protect and manage their remote office data.
- Acquisition of Airespace, Inc. to add to its portfolio of wireless local-area networking (WLAN) solutions and to add advanced features and capabilities to the Company's existing WLAN product portfolio.
- Acquisition of NetSolve, Incorporated to add remote network-management services, including real-time monitoring of IP communications networks, network security software, and network devices, to the Company's solutions offered to specialized resellers.
- Acquisition of P-Cube Inc. to provide additional control and management capabilities for advanced IP services, such as identifying subscribers, classifying applications, and accurately billing for content-based services, to service providers.
- Acquisition of the intellectual property and select other assets of, and hiring of a majority of the engineering team from, Procket Networks, Inc. to add to the Company's portfolio of intellectual property and to add a team of silicon and software architects.
- Acquisition of Topspin Communications, Inc. to add server fabric switches, a new class of server networking equipment that is designed to help improve resource utilization and reduce equipment and management costs, to the Company's switching product portfolio consisting of network and storage switches.

Fiscal 2004	Shares Issued	Purchase Consideration	Liabilities Assumed	In-Process R&D Expense	Purchased Intangible Assets	Goodwill
Latitude Communications, Inc.	—	$ 86	$ 29	$ 1	$ 16	$ 60
Other	—	41	7	2	8	30
Total	—	$ 127	$ 36	$ 3	$ 24	$ 90

- Acquisition of Latitude Communications, Inc. to add rich-media conferencing that combines voice, video, and Web conferencing to the Company's IP communications solutions.

The Consolidated Financial Statements include the operating results of each business from the date of acquisition. Pro forma results of operations for these acquisitions have not been presented because the effects of the acquisitions, individually or in the aggregate, excluding Scientific-Atlanta, were not material to the Company's results.

Notes to Consolidated Financial Statements

In-Process Research and Development

The Company's methodology for allocating the purchase price for purchase acquisitions to in-process research and development ("in-process R&D") is determined through established valuation techniques in the high-technology communications industry. In-process R&D is expensed upon acquisition because technological feasibility has not been established and no future alternative uses exist. Total in-process R&D expense in fiscal 2006, 2005, and 2004 was $91 million, $26 million, and $3 million, respectively. The acquisition of Scientific-Atlanta accounted for $88 million of the in-process R&D during fiscal 2006, which related primarily to projects associated with Scientific-Atlanta's advanced models of digital set-top boxes, network software enhancements and upgrades, and data products and transmission products.

Purchased Intangible Assets

The following table presents details of the purchased intangible assets acquired during fiscal 2006 and 2005 (in millions, except years):

	TECHNOLOGY		CUSTOMER RELATIONSHIPS		OTHER		
	Weighted-Average Useful Life (in Years)	Amount	Weighted-Average Useful Life (in Years)	Amount	Weighted-Average Useful Life (in Years)	Amount	Total
FISCAL 2006							
KiSS Technology A/S	**4.5**	**$ 11**	**5.5**	**$ 6**	**5.0**	**$ 2**	**$ 19**
Metreos Corporation	**4.5**	**1**	**—**	**—**	**2.0**	**1**	**2**
Scientific-Atlanta, Inc.	**3.5**	**546**	**7.0**	**1,346**	**2.0**	**57**	**1,949**
Sheer Networks, Inc.	**4.5**	**16**	**6.0**	**11**	**4.5**	**2**	**29**
SyPixx Networks, Inc.	**5.0**	**7**	**5.0**	**5**	**—**	**—**	**12**
Other	**5.0**	**35**	**6.5**	**6**	**—**	**—**	**41**
Total		**$616**		**$ 1,374**		**$ 62**	**$2,052**
FISCAL 2005							
Actona Technologies, Inc.	4.5	$ 21	—	$ —	—	$ —	$ 21
Airespace, Inc.	4.5	78	3.5	17	—	—	95
NetSolve, Incorporated	3.5	24	5.5	7	—	—	31
P–Cube Inc.	4.5	39	2.5	17	—	—	56
Procket Networks, Inc.	7.5	22	2.5	3	1.0	1	26
Topspin Communications, Inc.	4.5	39	6.0	28	—	—	67
Other	5.5	125	3.0	28	2.0	2	155
Total		$ 348		$ 100		$ 3	$ 451

The following tables present details of the Company's total purchased intangible assets (in millions):

July 29, 2006	Gross	Accumulated Amortization	Net
Technology	**$1,052**	**$(302)**	**$ 750**
Customer relationships	**1,535**	**(175)**	**1,360**
Other	**164**	**(113)**	**51**
Total	**$2,751**	**$(590)**	**$2,161**

July 30, 2005	Gross	Accumulated Amortization	Net
Technology	$ 880	$ (501)	$ 379
Customer relationships	188	(53)	135
Other	130	(95)	35
Total	$ 1,198	$ (649)	$ 549

Notes to Consolidated Financial Statements

The following table presents details of the amortization expense of purchased intangible assets as reported in the Consolidated Statements of Operations (in millions):

Years Ended	July 29, 2006	July 30, 2005	July 31, 2004
Reported as:			
Cost of sales	$ 60	$ —	$ 13
Operating expenses	393	227	242
Total	$ 453	$ 227	$ 255

During the year ended July 29, 2006, the Company recorded an impairment charge of $69 million from a write down of purchased intangible assets related to certain technology and customer relationships due to a reduction in expected future cash flows and the amount was recorded as amortization of purchased intangible assets in the Consolidated Statements of Operations.

The estimated future amortization expense of purchased intangible assets as of July 29, 2006, is as follows (in millions):

Fiscal Year	Amount
2007	$ 525
2008	466
2009	382
2010	274
2011	209
Thereafter	305
Total	$ 2,161

Goodwill

Beginning in fiscal 2006, the Company's reportable segments were changed to the following theaters: United States and Canada; European Markets; Emerging Markets; Asia Pacific; and Japan. As a result, the Company reallocated goodwill to these reportable segments. The following tables present the changes in goodwill allocated to the Company's reportable segments during fiscal 2006 and 2005 (in millions):

Fiscal 2006	Balance at July 30, 2005	Scientific-Atlanta Acquisition	Other Acquisitions	Other	Balance at July 29, 2006
United States and Canada	$3,304	$3,396	$ 120	$ (42)	$6,778
European Markets	744	338	28	17	1,127
Emerging Markets	253	28	11	—	292
Asia Pacific	266	—	11	—	277
Japan	728	—	25	—	753
Total	$5,295	$3,762	$ 195	$ (25)	$9,227

Fiscal 2005	Balance at July 31, 2004	Other Acquisitions	Other	Balance at July 30, 2005
United States and Canada	$ 2,702	$ 602	$ —	$ 3,304
European Markets	515	229	—	744
Emerging Markets	177	76	—	253
Asia Pacific	171	95	—	266
Japan	633	95	—	728
Total	$ 4,198	$1,097	$ —	$ 5,295

In the table above, "Other Acquisitions" includes $22 million and $30 million of goodwill recorded as part of the Company's purchase of the remaining portion of the minority interest of Cisco Systems, K.K. (Japan) during fiscal 2006 and fiscal 2005, respectively. In the table above, "Other" includes currency translation and purchase accounting adjustments recorded during fiscal 2006.

Acquisition of Variable Interest Entities

In April 2001, the Company entered into a commitment to provide convertible debt funding of approximately $84 million to Andiamo, a privately held storage switch developer. This debt was convertible into approximately 44% of the equity of Andiamo. In connection with this investment, the Company obtained a call option that provided the Company the right to purchase Andiamo. The purchase price under the call option was based on a valuation of Andiamo using a negotiated formula. On August 19, 2002, the Company entered into a definitive agreement to acquire Andiamo, which represented the exercise of its rights under the call option. The Company also entered into a commitment to provide nonconvertible debt funding to Andiamo of approximately $100 million through the close of the acquisition. Substantially all of the convertible debt funding of $84 million and nonconvertible debt funding of $100 million was expensed as R&D costs.

The Company adopted FIN 46(R) effective January 24, 2004. The Company evaluated its debt investment in Andiamo and determined that Andiamo was a variable interest entity under FIN 46(R). The Company concluded that the Company was the primary beneficiary as defined by FIN 46(R) and, therefore, accounted for Andiamo as if the Company had consolidated Andiamo since the Company's initial investment in April 2001. The consolidation of Andiamo from the date of the Company's initial investment required accounting for the call option as a repurchase right. Under FASB Interpretation No. 44, "Accounting for Certain Transactions Involving Stock Compensation," and related interpretations, variable accounting was required for substantially all Andiamo employee stock and options because the ending purchase price was primarily derived from a revenue-based formula.

Effective January 24, 2004, the last day of the second quarter of fiscal 2004, the Company recorded a noncash cumulative stock compensation charge of $567 million, net of tax (representing the amount of variable compensation from April 2001 through January 2004). This charge was reported as a separate line item in the Consolidated Statements of Operations as a cumulative effect of accounting change, net of tax. The charge was based on the value of the Andiamo employee stock and options and their vesting from the adoption of FIN 46(R) pursuant to the formula-based valuation.

On February 19, 2004, the Company completed the acquisition of Andiamo, exchanging approximately 23 million shares of the Company's common stock for Andiamo shares not owned by the Company and assuming approximately 6 million stock options, for a total estimated value of $750 million, primarily derived from the revenue-based formula, which after stock price-related adjustments resulted in a total amount recorded of $722 million, as summarized in the table below.

Subsequent to the adoption of FIN 46(R), changes to the value of Andiamo and the continued vesting of the employee stock and options resulted in an adjustment to the noncash stock compensation charge. The Company recorded a noncash variable stock compensation adjustment of $58 million in the third quarter of fiscal 2004 to the cumulative stock compensation charge recorded in the second quarter of fiscal 2004 to account for the additional vesting of the Andiamo employee stock and options and changes in the formula-based valuation from January 24, 2004 until February 19, 2004. This noncash adjustment was reported as operating expense in the Consolidated Statements of Operations, as stock-based compensation related to acquisitions and investments in the Consolidated Statements of Cash Flows, and as an increase to additional paid-in capital in the Consolidated Statements of Shareholders' Equity. In addition, upon completion of the acquisition, deferred stock-based compensation of $90 million was recorded in the Consolidated Balance Sheets to reflect the unvested portion of the formula-based valuation of the Andiamo employee stock and options. The amount of deferred stock-based compensation was fixed at the date of acquisition and was being amortized over the vesting period of the Andiamo employee stock and options of approximately two years.

A summary of the accounting of the initial consolidation under FIN 46(R) and the subsequent purchase of Andiamo, after stock price-related adjustments, is as follows (in millions):

	Amount
Cumulative effect of accounting change, net of tax benefit of $5	$567
Variable stock-based compensation	58
Deferred stock-based compensation	90
Net assets	7
Total	$722

In addition, in fiscal 2005, the Company completed other acquisitions of companies which had been consolidated prior to acquisition because the Company was deemed to be the primary beneficiary under FIN 46(R). The total purchase price of these acquisitions was an aggregate of $76 million, of which $45 million was to be paid over a five-year period. These amounts may be increased by approximately $134 million depending upon the achievement of certain development and product milestones. The purchase consideration consisted of cash, stock, and fully-vested stock options assumed. Deferred stock-based compensation of $7 million was recorded in the Consolidated Balance Sheets in connection with these acquisitions. There were no acquisitions of variable interest entities in fiscal 2006.

Notes to Consolidated Financial Statements

Compensation Expense Related to Acquisitions and Investments

The following table presents the compensation expense related to acquisitions and investments (in millions):

Years Ended	July 29, 2006	July 30, 2005	July 31, 2004
Stock-based compensation expense related to acquisitions and investments	$ 87	$ 154	$ 244
Cash compensation expense related to acquisitions and investments	36	11	—
Total	$123	$ 165	$ 244

For the year ended July 31, 2004, the Company recorded a noncash charge for the cumulative effect of accounting change related to stock-based compensation expense of $567 million, net of tax. Beginning in fiscal 2006, stock-based compensation related to acquisitions and investments is calculated under SFAS 123(R) and includes deferred stock-based compensation relating to acquisitions completed prior to fiscal 2006. As of July 29, 2006, the remaining balance of stock-based compensation to be recognized over the vesting periods was approximately $70 million. Prior to fiscal 2006, a portion of the purchase consideration for purchase acquisitions was recorded as deferred stock-based compensation. Deferred stock-based compensation represented the intrinsic value of the unvested portion of any restricted shares exchanged, options assumed, or options canceled and replaced with the Company's options and was amortized as stock-based compensation expense related to acquisitions over the remaining respective vesting periods. The balance for deferred stock-based compensation was reflected as a reduction to additional paid-in capital in the Consolidated Statements of Shareholders' Equity. The following table presents the activity of deferred stock-based compensation for the fiscal years ended July 30, 2005 and July 31, 2004 (in millions):

	July 30, 2005	July 31, 2004
Balance at beginning of fiscal year	$ 153	$ 262
Purchase acquisitions	128	94
Amortization	(140)	(186)
Canceled unvested options	(4)	(17)
Balance at end of fiscal year	$ 137	$ 153

In connection with the Company's purchase acquisitions and asset purchases, the Company has agreed to pay certain additional amounts of up to $90 million in cash contingent upon achieving certain agreed-upon technology, development, product, or other milestones or continued employment of certain employees with the Company. In each case, any additional amounts paid will be recorded as compensation expense. As of July 29, 2006, the Company has recorded $21 million of additional compensation expense pursuant to these agreements, all of which was recorded during fiscal 2006.

In connection with the Company's acquisitions of variable interest entities, the Company has agreed to pay certain additional amounts of up to $180 million in cash contingent upon achieving certain agreed-upon technology, development, product, or other milestones or continued employment of certain employees with the Company. In each case, any additional amounts paid will be recorded as compensation expense. During fiscal 2006, the Company recorded $15 million of additional compensation expense pursuant to these agreements. As of July 29, 2006, the Company has recorded an aggregate of $26 million of additional compensation expense pursuant to these agreements.

Notes to Consolidated Financial Statements

4. Balance Sheet Details

The following tables provide details of selected balance sheet items (in millions):

	July 29, 2006	July 30, 2005
Inventories:		
Raw materials	$ 131	$ 82
Work in process	377	431
Finished goods:		
Distributor inventory and deferred cost of sales	423	385
Manufacturing finished goods	236	184
Total finished goods	659	569
Service-related spares	170	180
Demonstration systems	34	35
Total	$ 1,371	$ 1,297
Property and equipment, net:		
Land, buildings, and leasehold improvements	$ 3,647	$ 3,492
Computer equipment and related software	1,352	1,244
Production, engineering, and other equipment	3,678	3,095
Operating lease assets	153	136
Furniture and fixtures	363	355
	9,193	8,322
Less accumulated depreciation and amortization	(5,753)	(5,002)
Total	$ 3,440	$ 3,320
Other assets:		
Deferred tax assets	$ 983	$ 1,308
Investments in privately held companies	574	421
Income tax receivable	279	277
Lease receivables, net	464	353
Other	511	350
Total	$ 2,811	$ 2,709
Deferred revenue:		
Service	$ 4,088	$ 3,618
Product		
Unrecognized revenue on product shipments and other deferred revenue	1,156	1,201
Cash receipts related to unrecognized revenue from two-tier distributors	405	223
Total product deferred revenue	1,561	1,424
Total	$ 5,649	$ 5,042
Reported as:		
Current	$ 4,408	$ 3,854
Noncurrent	1,241	1,188
Total	$ 5,649	$ 5,042

5. Lease Receivables, Net

Lease receivables represent sales-type and direct-financing leases resulting from the sale of the Company's and complementary third-party products and services. These lease arrangements typically have terms from two to three years and are generally collateralized by a security interest in the underlying assets. The current portion of lease receivables, net, is recorded in prepaid expenses and other current assets, and the noncurrent portion is recorded in other assets in the Consolidated Balance Sheets. The net lease receivables are summarized as follows (in millions):

	July 29, 2006	July 30, 2005
Gross lease receivables	$ 960	$ 731
Unearned income and other allowances	(188)	(130)
Total	$ 772	$ 601
Reported as:		
Current	$ 308	$ 248
Noncurrent	464	353
Total	$ 772	$ 601

Contractual maturities of the gross lease receivables at July 29, 2006 were $369 million in fiscal 2007, $302 million in fiscal 2008, $177 million in fiscal 2009, $81 million in fiscal 2010, and $31 million in fiscal 2011 and thereafter. Actual cash collections may differ from the contractual maturities due to early customer buyouts, refinancings, or defaults.

6. Investments

The following tables summarize the Company's investments (in millions):

July 29, 2006	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Fixed income securities:				
U.S. government notes and bonds	$ 5,179	$ 3	$ (47)	$ 5,135
Corporate notes, bonds, and asset-backed securities	7,950	2	(88)	7,864
Municipal notes and bonds	809	—	(3)	806
Total fixed income securities	13,938	5	(138)	13,805
Publicly traded equity securities	467	252	(7)	712
Total	$14,405	$ 257	$ (145)	$14,517

July 30, 2005	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Fixed income securities:				
U.S. government notes and bonds	$ 3,453	$ 2	$ (25)	$ 3,430
Corporate notes, bonds, and asset-backed securities	6,299	3	(63)	6,239
Municipal notes and bonds	705	—	(2)	703
Total fixed income securities	10,457	5	(90)	10,372
Publicly traded equity securities	514	433	(6)	941
Total	$ 10,971	$ 438	$ (96)	$ 11,313

The following table presents gross realized gains and losses related to the Company's investments (in millions):

Years Ended	July 29, 2006	July 30, 2005	July 31, 2004
Gross realized gains	$ 141	$ 144	$ 208
Gross realized losses	(88)	(61)	(2)
Total	$ 53	$ 83	$ 206

The gross realized losses in fiscal 2005 included charges of $5 million related to the impairment of certain publicly traded equity securities. The impairment charges were due to a decline in the fair value of the investments below their cost basis that were judged to be other-than-temporary. There were no impairment charges related to publicly traded equity securities in fiscal 2006 or fiscal 2004. The following tables present the breakdown of the investments with unrealized losses at July 29, 2006 and July 30, 2005 (in millions):

	UNREALIZED LOSSES LESS THAN 12 MONTHS		UNREALIZED LOSSES 12 MONTHS OR GREATER		TOTAL	
July 29, 2006	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
U.S. government notes and bonds	$ 3,263	$ (33)	$ 644	$ (14)	$ 3,907	$ (47)
Corporate notes, bonds, and asset-backed securities	2,420	(18)	1,968	(70)	4,388	(88)
Municipal notes and bonds	146	(1)	103	(2)	249	(3)
Publicly traded equity securities	41	(6)	2	(1)	43	(7)
Total	$ 5,870	$ (58)	$ 2,717	$ (87)	$ 8,587	$ (145)

	UNREALIZED LOSSES LESS THAN 12 MONTHS		UNREALIZED LOSSES 12 MONTHS OR GREATER		TOTAL	
July 30, 2005	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
U.S. government notes and bonds	$ 2,947	$ (21)	$ 220	$ (4)	$ 3,167	$ (25)
Corporate notes, bonds, and asset-backed securities	4,388	(52)	531	(11)	4,919	(63)
Municipal notes and bonds	260	(2)	—	—	260	(2)
Publicly traded equity securities	34	(5)	4	(1)	38	(6)
Total	$ 7,629	$ (80)	$ 755	$ (16)	$ 8,384	$ (96)

The gross unrealized losses related to fixed income securities were primarily due to changes in interest rates. The gross unrealized losses related to publicly traded equity securities were due to changes in market prices. The Company's management has determined that the gross unrealized losses on its investment securities at July 29, 2006 are temporary in nature. The Company reviews its investments to identify and evaluate investments that have indications of possible impairment. Factors considered in determining whether a loss is temporary include the length of time and extent to which fair value has been less than the cost basis, the financial condition and near-term prospects of the investee, and the Company's intent and ability to hold the investment for a period of time sufficient to allow for any anticipated recovery in market value. Substantially all of the Company's fixed income securities are rated investment grade. The following table summarizes the maturities of the Company's fixed income securities at July 29, 2006 (in millions):

	Amortized Cost	Fair Value
Less than 1 year	$ 3,412	$ 3,398
Due in 1 to 2 years	3,752	3,723
Due in 2 to 5 years	5,555	5,470
Due after 5 years	1,219	1,214
Total	$13,938	$13,805

Actual maturities may differ from the contractual maturities because borrowers may have the right to call or prepay certain obligations.